Appendix 2
Banking System

"It is not, as described by others, collapsing."[1] Dai Xianglong, head of China's central bank, must be feeling the heat--he obviously felt compelled to rebut all the talk about serious problems in China's financial sector. Dai is right, but nobody has said that the system is collapsing *today*. Analysts point out the obvious: no system like China's can last forever. The issue is what will happen *tomorrow*.

At present, China's banking crisis is a silent one. The major state banks, the Big Four[2] as they are known, are insolvent. Worse, the effort to bail them out is not working. Think of it this way: these banks are sitting atop the San Andreas Fault and the earth is starting to rumble.

The most important statement that can be made is this: the crisis in the Chinese banking system is perhaps the most serious in the world today.[3] The cause of the problem is not hard to understand. The Big Four, over the course of just about a decade, have squandered the savings of a great people at the direction of the government in Beijing.

State officials talk about the bank's problems as if they had accumulated over decades.[4] Technically, that is true. But the reality is that most of those problems have arisen in the recent past.[5] Senior technocrats tried to reform state-owned enterprises by replacing direct subsidies from the central treasury with loans from the four biggest banks.

The theory was sound: wean the sick SOEs off of grants and make them self-sufficient. In practice, the plan was a disaster: managers of state enterprises knew they didn't have to pay back the banks. So they didn't. In an economic system divorced from economic reality, in a China where there were few penalties for failure in the marketplace and almost no accountability, banks effectively became gift givers. They essentially took cash from small savers and gave it to state enterprises at the direction of officials all over China. The process was bound to result in nonperforming loans for the banks.

The massive transfer of assets from the banks to the enterprises is a matter of indifference to central government technocrats. After all, the state owns both the enterprises and the banks. It is, however, a matter of concern to hundreds of millions of China's savers. Year after year they squirrel away a sum that is equal to about 40 percent of gross domestic product. That puts them atop the global rankings for thriftiness. As noted above, household savings were US$954.1 billion at the end of the first quarter of this year.[6] The Chinese are not just squirrels, they are world champion squirrels.
The Chinese can deposit, but can they withdraw? Today, the Big Four banks, which hold

somewhere in the neighborhood of 60 percent of the deposits and make about 66 percent of the loans, are insolvent. Few analysts, if any, have a good understanding of the extent of the problem loans, and perhaps no one really knows. "There is no simple answer to finding the level of nonperforming loans among state-owned banks," admits a high official at one of the largest of them.[7] Before the last partial recapitalization, which began in 1999, the best guess as to the percentage of nonperforming loans was about 50 percent. That is the estimate of an internal Deutsche Bank study. The range of disagreement at that time was huge: the upper limit was 70 percent and the lower one about 25 percent.

Beginning in 1999 the central government recapitalized the Big Four by taking US$157.0 billion of nonperforming debt off their books. After the partial recapitalization, the People's Bank of China, the central bank, said that nonperforming loans constituted about 25 percent of the Big Four's portfolios. That figure is taken as gospel by some analysts today, but we have to remember that the central bank before the recapitalization also said that the percentage of nonperforming loans was 25 percent. In other words, the biggest bank recapitalization in Chinese history had no apparent effect on the balance sheets of the Big Four. When it comes to their own statistics, China's central bankers have lost credibility.

In fact, almost all the estimates of these loans were correct: any one was essentially as good as any other. You could just about justify any percentage in the range depending upon the standards you used for classifying loans. The country's central bank allowed the country's commercial bankers to adopt the loosest of them. In the last few years classification rules have been tightened, but today devious techniques allow even the worst loans to appear good. The Big Four have continually "rolled over" troubled loans so that they appear on their books to be new ones.

So what is the condition of the Big Four today? Again, the best work of the analysts is still guesswork. The central bank claims that nonperforming loans fell during last year by US$11.0 billion to 25.37 percent.[8] That number surely understates the problem: the estimates of the People's Bank have always been too low. Dai Xianglong, the head of that bank, has recently admitted that nonperforming loans may be as high as 30 percent of total lending.[9] Dai's public comments over the years have consistently underestimated the level of nonperforming loans, so his new 30 percent figure provides us with the low end of the range.[10] Some observers guess 50 percent.[11]

The condition of each of these mammoth banks varies widely, however. One observer has been recently quoted as saying that the rotten loans of the Agricultural Bank of China could constitute as much as 90 percent of its total portfolio.[12] That percentage sounds way too high, but nonetheless this bank needs emergency room treatment.

The hunt for an accurate figure for nonperforming loans is an interesting exercise, of course. Yet the big news in China's banking system is not how sick the banks are today. The issue is the ongoing creation of new bad loans. The Commercial Banking Law, adopted in 1995, made China's banks responsible for their own operations and, at least as a theoretical matter, freed them from outside political interference. As a practical matter, however, the Communist Party and the central government continue to treat the Big Four as a "secondary budget," a convenient source of funding for all sorts of social purposes.

Today, observers report that Party and government officials have begun to exercise restraint in using the Big Four as their piggy banks. Yet this good news is a bit premature. For one thing, these financial institutions have continued their lending to state enterprises because there is still a reluctance to do business with the private sector. Figures vary, but it appears that state enterprise loans comprise more than 90 percent of the total portfolios of the Big Four.

More important, senior officials cannot seem to keep their hands off the banks. Premier Zhu Rongji, for instance, promised to reform state enterprises in three years, but he went about fulfilling his pledge by forcing state banks to make even more loans.[13] And almost no one has noticed another by-product of the premier's financial engineering: the state banks, especially the Big Four, have had to step up their lending to further fuel growth as a part of his stimulus program. The most recent imposition on the banks is the central government's plan to use bank funds to prop up the domestic equity markets. Soon banks will take stock as collateral for loans to stock speculators.[14] So the central government continues to aggravate the problem loan problem. In any event, while Beijing figures out what the banks can do next to support state policies, the amount of liabilities continues to grow at the annual rate of around 2 percent of GDP.[15]

These big banks not only support the state indirectly. Today, the central government itself is borrowing from its own institutions. About half of its announced expenditures is funded by the proceeds of sovereign treasury issues, and the state banks are dutifully taking up these low-interest obligations as they are issued. Worse, the big banks are forced to buy the bonds of nonsovereign state borrowers.[16] When the Big Four run out of liquidity because of their purchase of all this debt, as they do from time-to-time, the People's Bank of China provides interim funding to tide them over. Money, therefore, is circulating in a closed system, many parts of the state financing each other at the same time.

So how long can this circular flow of cash continue? The Big Four have committed many sins, but the worst may be borrowing short and lending long. That's the classic formula for default for financial institutions around the world. China's biggest banks take deposits from individuals, and these deposits must be paid back either on short notice or on demand. The loans to state enterprises are essentially long-term. Consequently, the Big Four banks can continue to support state purposes only as long as China's savers continue to place their faith in the system by making more deposits.

And how long will China's savers save with the state? The consensus view is that they will do so indefinitely. That is, however, not possible: nothing insolvent lasts forever. Moreover, there are forces now at work that effectively fix a deadline. First, the state itself is trying to develop the equity markets in Shanghai and Shenzhen. Moreover, foreign and domestic insurers are touting their products to the public as new forms of savings. So as China's squirrels find alternative means of investment, the seemingly endless flow of new deposits is diverted to nonbanking institutions.

Second, foreign banks will be able to take local currency deposits from local residents in five years pursuant to China's agreement to join the World Trade Organization. There are about 200 foreign banks in China now, but they remain marginal players with almost no deposits and less than five percent of the loans.[17] Although foreign banks may not attract many deposits in the future, only a small reduction in the flow of funds to the Big Four may be enough to cause trouble. Already there are reports that domestic banks are not able to honor requested withdrawals.

Third, declining interest rates do not help the banks. In February China's central bank announced its eighth straight interest rate cut as a means of stimulating a stagnating economy. The Big Four and other state banks have lost funds to the illegal deposit-takers in the past. From units of the Communist Party to the entrepreneurial couple next door, unauthorized parties are effectively competing against the banks by offering relatively high rates of interest on deposits. The state has begun to execute those who offer attractive interest rates, but the central government cannot catch all those who are merely responding to the call of the market.

And then there is irrationality. Every once in a while China's docile savers go on the rampage as they withdraw their money in stampedes with passbooks. In April 1999, for example, depositors withdrew US$108 million in the course of just a few days from the Bank of Communications, generally acknowledged to be the strongest of all of China's state-owned banks. Rumors posted on the Internet about the embezzlement of a bank manager triggered the massive withdrawals. Even the Big Four have suffered bank runs.

The Chinese people have withdrawn their money for the craziest of reasons and for no reason at all. Yet unbeknownst to most of them, they already have the best rationale to start a run: their banks are insolvent. What will happen when they find out?

The state hopes that it can rehabilitate the banks before China's savers learn the true state of affairs. Unfortunately, Chinese officials subscribe to the concept of slow reform when time is the critical element. When it comes to fixing sick banks, the lesson learned around the world is that faster is always better.

The four largest of China's commercial banks should have been rehabilitated by now. After all, the Big Four have just benefitted from two partial recapitalizations. In 1998 China's Ministry of Finance injected a sum equal to US$32.5 billion into them. Without providing details, the People's Bank of China said the recapitalization had lifted their capital adequacy ratios to 8 percent,[18] the international standard. It was a rather large fib,[19] and few were fooled. At the time, however, it seemed like a step in the right direction.

Then came the real deal: US$157.0 billion of relief for the Big Four. Four newly-formed asset management companies, one for each of these behemoths, were formed beginning in April 1999. The AMCs, as they are now known, took from these banks nonperforming loans. In return, the banks would receive bonds issued by the Ministry of Finance. This was, in the words of Dai Xianglong, the end of the line for bailouts for the Big Four. "I consider the establishment of the asset-management companies as the last dinner for the state-owned commercial banks," said Dai. "I know some people are expecting midnight snacks or breakfast the next morning, but I don't think this will be possible."[20]

So are the Big Four ready to face the future now that they have had their last meal? These financial institutions look more modern today and their balance sheets are stronger, but they may be no nearer to a solution than they were a half decade ago. That's because the AMC program was misconceived from the very beginning. First, the funding was not nearly enough. Beijing was not even willing to spend a third of the amount needed to put the banks on a sound footing.

The AMCs were modeled on the Resolution Trust Corporation, which acquired the assets of failed savings and loans in the United States in the early 1990s. The RTC worked well in America, but the AMCs are failing in China. This we know: when it comes to restructuring commercial banks, only decisive action works. "Do it quickly, do it big, and do it just once," is the lesson from bank bailouts from around the world.[21] Partial recapitalizations don't change bad lending practices. In fact, incomplete recapitalizations encourage reckless lending because bankers know that there will be further handouts (or to use the central bank's metaphor, there must be more banquets).

The RTC worked because it was a typical American solution: recognize a problem, take losses quickly, and move on. But in the People's Republic technocrats and Communist Party bosses proceed cautiously. Beijing's solution is to implement slowly and in many small steps, and as a result its program to save the banks itself needs rescue. The aftershocks of a banking crisis are felt for years even if a government moves fast.[22] When it does not, the crisis might never end. That could be China's fate. The AMCs move in slow motion when the critical element is speed. Recovery of banks, crucial to China's future, is being postponed again. As a result, there could be no end to the cycle of bank bailouts: Premier Zhu Rongji in his March 5 work report to the National People's Congress talked about a new round of bank recapitalizations.

Second, the program was designed to assist state borrowers as much as the banks. "Cinda's main mission is to help enterprises restructure, because an outright liquidation will bring losses to creditors and hardship to the workers,"[23] says Fang Xinghai, the first head of a committee coordinating matters between China Cinda Asset Management Corp., the first AMC, and China Construction Bank. Fang tells us the AMCs should help *state enterprises*. He forgets that they are supposed to rescue the *banks*. Curing the enterprises is a worthy goal, but it's not the same as saving these financial institutions.

Third, the asset management companies were given a virtually impossible task. "As a shareholder of the indebted firm, Cinda can exert pressure on management to produce a better financial return," Fang Xinghai says.[24] The concept was that the AMCs could fix the enterprises, which could then retire their debt. The idea, however, ignores reality: the remedies Fang suggests have been tried before without success. How can anyone think that the newly-created AMCs, as minority shareholders, will bring about meaningful change when the central government, as a sole or majority shareholder, was not able to do so for over two decades? So far, the AMCs look like a failure as they have had little effect on the management of state borrowers.[25]

In fact, the AMCs are faltering, even at this early date. As the program began, technocrats in the Chinese capital estimated that the new companies would recover at least 30 percent and possibly as much as 40 percent of the debt,[26] but that was delusional. Foreign estimates put anticipated recoveries at 10 percent,[27] a figure consistent with experience in bankruptcies in China.[28]

It is true that one of the AMCs claims to have recovered 54 percent of assets in 2001.[29] Even if that number is accurate--and we have to remember that when it comes to banking statistics China has no credibility--the AMCs have been carefully selecting their best assets for the first sales. Specific transactions that have been announced show far lower percentages of recovery--around the predicted 10 percent figure.[30]

Now the heads of the four AMCs are forecasting that they will salvage less than 30 percent of the face value of assets. Bank of China's AMC, China Orient, admitted that it's recovery rate was 24.25 percent from the time of its formation until the end of 2001.[31] And because the best assets are being sold first, the rate of recovery will undoubtedly sink in the years ahead. That's why the AMCs now hope for about 15 percent recovery rates.[32] If that's not bad enough, there's another problem: the volume of transactions will also decline. The first AMC, Cinda, recently announced that its pace of disposals would slow in the future.[33] The AMCs disposed only one-eighth of their total assets by the end of last year.[34]

We should not be disappointed: the AMC plan was never realistic to start out with. Everyone knew at the beginning of the program that outside money was needed. Yet even today many parts of the economy are not open to foreign investors, so they will not be able to buy much of the debt held by the AMCs. The asset management companies are beginning to complain. Cinda's president, Zhu Dengshan, recently announced that his AMC was running up against regulatory constraints that made disposals of assets difficult.[35] He was only talking about technical problems--he did not even begin to tackle the main issues blocking foreign acquisition of AMC assets. These restrictions are still too politically sensitive in China to discuss at this time.

So the central government shouldn't place too much hope on the AMCs. Jack Rodman, an advisor to one of them, has tried to put the best face on the situation by calling nonperforming loans "tarnished angels," but not many investors are attracted by his "treasure chest" of bum obligations.

So where is the central government going to find the funds to fix the banks? There are two initiatives these days. First, the central bank is hoping that the Big Four grow themselves out of their problems by using profits generated from operations to strengthen balance sheets. Dai Xianglong has said that these banks must reduce their nonperforming loans as a percentage of total lending by two or three percentage points every year.[36] Even if this plan proceeds, arithmetic says the cure could require decades. One financial specialist at the Shanghai Stock Exchange thinks that it will take 50 years.[37]

A slightly more realistic program is selling stock in each of the Big Four sometime in the next five years. Plans to do so have received a recent setback, however. Bank of China, the nation's largest foreign exchange dealer, was recently thought to be the most profitable, strongest, and most modern of the Big Four. Therefore, it was scheduled to be the first bank to enter the public markets, perhaps as early as the first half of this year. Today, the proposed listing of its Hong Kong unit is in tatters. Wang Xuebing, "the celebrity face of China's push to reform its troubled banking sector"[38] and Premier Zhu Rongji's protégé,[39] was detained in January of this year. The former head of Bank of China stands accused, among other crimes, of embezzling tens of millions of U.S. dollars with the help of his wife.[40]

This scandal by itself was enough to put China's listing plans on hold. Wang's alleged fraud is not a large one, however. A few of the bank's managers in Kaiping, a backwater city in Guangdong Province, made off with something in the neighborhood of US$725 million according to reports.[41] Their fraud was not discovered until the suspects fled.[42] China's National Audit Office said that the amount stolen was only US$320 million,[43] but the Bank of China now admits the sum is US$483 million.[44] Anyway you look at it, the Guangdong losses are "the biggest financial scandal in the history of modern China."[45] Senior Chinese officials do not seem to be too worried about the mess. Zhu Rongji, for one, dismissed the problems at Bank of China by saying that it was not "too surprising" to find irregularities.[46]

A Bank of China spokesman, and Premier Zhu, assure us that the bank's listing plans are going ahead as scheduled.[47] Yet delay is inevitable, as investor comments indicate;[48] equity markets cannot ignore news of this magnitude. Recent, and ongoing, events at that bank show that the problems are not just caused by a few bad apples.

"Every bank in China has problems like this," said one Chinese banking expert. "Even within the Bank of China, I think you can find worst abuses going on. This sort of problem is a product of the system, and unless the system changes, these kinds of problems may decrease but they won't disappear."[49]

Bank of China officials also tell us that they have immediately corrected all their flaws, but pronouncements of that sort are simply difficult to believe. "The authorities have no idea what is happening in their banks," observed a foreign banker recently.[50]

In China we have seen the central government spend substantial sums rehabilitating the banks. But let's not mistake activity for progress or confuse the talk of reform with reform itself. "If you compare the financial system with [that of] five years ago, not much has really changed," says Song Guoqing, a noted Beijing University professor. "It will probably be much the same in five years' time."[51]

It is certainly not beyond the Chinese government to waste another half decade. It is now being reported that the Wang Xuebing scandal is helping conservative Beijing leaders delay liberalization (as if that were an option).[52] Nonetheless, we cannot blame conservatives for not trusting the technocrats, who are responsible for creating most of the problems. The banking system shows the failure of the reform process over the past few years.

Today, two years after the latest recapitalization ended, the Big Four banks have yet to receive the Ministry of Finance bonds that were going to be used to pay for all the debt transferred to the AMCs. How can the Big Four be called "banks" when they surrender tens of billions of dollars of assets with just an understanding of payment in the indefinite future. No wonder the state commercial banking system is in trouble.

And state commercial banks are not the only institutions that are financially challenged. The trust companies and rural credit cooperatives are in much worse shape than the Big Four by all accounts.

Up to now, the state has avoided social unrest by implicitly standing behind all deposit takers, even some of the illegal ones.[53] When institutions have failed, local governments, sometimes with the assistance of the center, have paid back deposits from their own funds. Because the social consequences of a failing banking system have been avoided, the central government has been able to postpone implementation of most structural reform of the banks. At some point, the Communist Party must push forward with such reform or face the inevitable social unrest that results from bank failures (not to mention the failure of other deposit takers).

Laurence J. Brahm, a widely-quoted businessman in Beijing, says: "The Chinese government is not stupid enough to allow the state-owned banking system to collapse."[54] We all hope Brahm is right. Yet when we look at the facts it is not clear that the technocrats, who caused most of the problems in the first place, are smart enough to rescue the banks.

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